

Thriving Through Recession

Higher education in a down economy

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The constant flow of alarming economic and business news, rapidly declining endowments and potential disruption to the student-loan industry have all beaten down optimism about higher education's financial and strategic outlook. In January 2009, Moody's Investors Service for the first time in its history assigned a negative outlook to the higher education industry (both private and public universities).

Universities large and small have announced budget cuts, layoffs, salary freezes, capital spending slowdowns and other initiatives to batten down the hatches for the recession. Concern for the financial position of colleges and universities is well-founded, given the large degree of uncertainty about the future of the U.S. and global economy. Clearly, 2009 will be a year of re-evaluation of underlying assumptions for endowment management, tuition pricing strategies and risk management. Given the critical economic development role of higher education, sound management skills and governance oversight will be particularly critical to ensure that universities are drivers in helping the nation emerge from recession and are themselves well-positioned to survive and thrive.

Moody's negative outlook on the industry is fundamentally driven by four key issues:

- the impact of job losses and greater economic uncertainty on enrollment decisions of families and students, rising financial aid needs and more limited financing options (student loan, home equity, etc.);
- investment losses in the endowment which affect not only funds available for operations, but also credit strength, capital spending and potential for fundraising from wealthy donors;
- limited liquidity of cash and investments as many investments in hedge funds, private equity, and venture capital are locked up; and
- access to debt financing in capital markets that is more challenging and costly (higher interest rates and bank fees), exacerbated by colleges' use of variable-rate debt.

Tuition Tipping Point?

With the vast majority of colleges reliant on tuition, fees and auxiliary charges for greater than 80% of revenues, the largest long-term risk remains that the industry reaches a tipping point in a long

trend line of rising net tuition revenue.

While the trend has not been disrupted by prior recessions, this cycle could prove different. First, tuition and room and board charges are at their highest levels, and in many cases, sticker prices are beginning to exceed \$50,000 per year, raising some psychological barriers to hiking tuition still further. Even private and public colleges that do not charge this high amount have nevertheless repeatedly raised tuition well in excess of the growth in family incomes. Second, while households have faced declining net worth due to investment losses in the past, we have not seen such dramatic investment declines combined with large declines in home-equity values at the same time. As a result, the percent loss in household net

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worth is the largest we have seen in decades. Because few families pay tuition solely from annual income, household net worth and access to loans (student loans and others) may be a better proxy for the ability of families to afford tuition.

Given these issues, challenges will be somewhat greater for private colleges and universities than for their public counterparts. Enrollments are likely to shift from higher-cost private institutions to lower-cost publics, generally helping public universities. However, state budgets are extremely weak, and public universities will likely face some of the deepest cuts in appropriations in recent memory. Although stimulus bill spending may soften the cuts in the new term, the outlook for appropriations will likely remain weak for some time. While they are accustomed to adjusting to falling state support, the combination of rising demand and falling appropriations will certainly cause budget stress, especially in FY2010.

With all the concerns about the risk of fundamental change in the industry, Moody's has repeatedly emphasized the importance of sound management and governance to weather the downturn and prepare institutions for change. Colleges are often not well-structured to rapidly adjust to changing environments. They are typically highly decentralized organizations driven by consensus

decision-making. These characteristics are particularly difficult to sustain in an environment that has been changing as rapidly as the economic, investment and capital markets have been.

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Following are some principles and actions that are consistent with good financial management and stewardship of higher education institutions during a severe recession. These principles would also help prepare colleges and universities to be more nimble organizations in the future.

Plan conservatively and measure results.

- Devise multiple fully developed budgets that include scenarios of shortfalls in enrollment, on-target enrollment and enrollment that exceeds target.
- Measure financial performance of individual programs and departments. While financially weak departments do not necessarily need to be closed, clarity of information can better inform future decisions for investment and ability to scale back.
- Prepare off-the-shelf ways to reduce expenses if necessary, even if cuts have not yet been made.

Build transparency and a service orientation.

- Meet tremendous demand for better information from policymakers, families, donors and investors.
- Build trust and potential for enhanced government support by improving clarity and transparency.
- Market and describe financial aid available to families. Having generous financial aid policies isn't enough if families don't understand them. Institutions risk losing students because of perception of affordability, rather than reality.
- Develop robust conflict-of-interest policies that are publicized and followed throughout the organization from the board level to the academic departments.
- Encourage service-oriented information and guidance about program quality and career opportunities for all stakeholders, including current and former students, not just prospective students being recruited.

Revisit risk-management approach.

- Explore unknown risks. The credit crisis has exposed risks that were previously thought to be de-minimis; what else is out there?
- Introduce risk-management process (including enterprise risk management) to board's agenda. It is the board's responsibility to ensure that universities have examined exposures to risks, including counterparty risk in financial transactions and reputation risk of programs and research.

Reasons for Optimism

Despite the challenges, universities are remarkably resilient organizations and are a crucial part of the road to economic recovery. Long-term demand for higher education is unlikely to change substantially. Education remains a key tool to individual economic success and employment. Promising industries such as green energy and biotechnology are heavily reliant on the academic research engine.

Universities also have considerable financial flexibility. They have generally invested heavily in capital over the past decade and should have room to delay or cancel capital projects. Quasi-endowments and other reserves have grown very rapidly over the past decade and despite the potential decline of 30% or more in endowment values in FY2009, overall wealth levels would generally retreat by only about six years (to values in 2003).

Operationally, we expect there to be significant opportunities for cost reduction and improved efficiencies in budgeting at most universities. The actions, which may include slight increases in average class size or greater use of adjunct faculty, could relieve pressure on rising tuition rates. Lastly, while philanthropy is likely to slow, universities have some of the most committed and loyal donors in the nonprofit world, which should position them well to minimize declines and rebound more rapidly. As long as managers and trustees of universities balance the need to protect institutions from the risks of the recession and the need to invest and be participants in economic recovery, higher education should remain a core competitive advantage for New England and a key part of recovery.

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